The range of exposures facing directors and officers (D&Os) – as well as the resultant claims scenarios – have increased significantly in recent years. With corporate management under the spotlight like never before, Allianz Global Corporate & Specialty (AGCS) experts provide both a reflection of the current state of the D&O insurance market and also point the lens forward to five mega trends which lie ahead, impacting risk managers, their D&Os and their broker partners.
AGCS continues to see more claims against D&Os emanating from “bad news” not necessarily related to financial reports. Scenarios include product problems, man-made disasters, environmental disasters, corruption and cyber-attacks. These types of “event-driven litigation” cases often result in significant securities or derivative claims from shareholders after the bad news causes a share price fall or a regulatory investigation.

Plaintiffs seek to relate the “event” to prior company or board statements of reassurance to shareholders and regulators of no known issues. Of the top 100 US securities fraud settlements ever, 59% are event-driven\(^1\). The likelihood that a public company will be sued in a securities class action at some point is increasing – from 3.5% in 2014 to 8.5% in the first half of 2018\(^2\).

One of the most prevalent types of these events is cyber-related claims covered under D&O insurance. AGCS has seen a number of securities class actions, derivative actions and regulatory investigations and fines, including from the EU’s General Data Protection Regulation (GDPR), in the last year, and expects an acceleration in 2020. Companies and boards increasingly will be held responsible for data breaches and network security issues which cause loss of personal information or significant impairment to the company’s performance and reputation.

Companies suffering major cyber or security breaches increasingly are targeted by shareholders in derivative litigations alleging failure to institute timely protective measures for the company and its customers. Such breaches increasingly are driving underlying US securities class action litigation by shareholders alleging failure to disclose the company’s exposure to potential breaches and the lack of avoidance preparation. The Marriott case is a recent example of cyber breaches that became D&O claims – one $12.5bn lawsuit among several filings alleges a “digital infestation” of the company, unnoticed by management, caused customer personal data to be compromised for over four years\(^3\).

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2. Willis Towers Watson, The rise in event-driven securities litigation – Why it matters to directors and officers, November 12, 2018
3. Consumer Affairs, Marriott sued after disclosing breach of reservation system: One lawsuit seeks $12.5bn in damages, December 3, 2018
Reputation is a core concern of companies. According to the Allianz Risk Barometer 2019 survey of customers and Allianz experts, “loss of reputation or brand value” ranks as the ninth top business risk overall. Environmental, social and governance (ESG) failings often cause brand values to plummet. The social media temperature of a company is a factor examined by D&O underwriters to gauge reputational views.

Investors, regulators, governments and the public increasingly expect companies and their boards to appropriately focus on ESG issues. For example, climate change is one of the issues rising to the top of boards’ risk registers; failure to disclose climate change risks may drive litigation in the coming years. Climate change cases have been brought in at least 28 countries around the world to date with three-quarters of those cases filed in the US. In the US, there are an increasing number of cases alleging that companies have failed to adjust business practices in line with changing climate conditions.

Human exploitation in the supply chain is another disrupter and illustrates how ethical topics can cause D&O claims. Such topics can also be a major focus for activist investors, whose numbers of US campaigns grew by almost 6% year-on-year in 2018 to 268.

Appropriate company culture is a strong defense risk-mechanism. Many studies show board diversity helps reduce and foresee risk. Disparate corporate scandals faced by Equifax, Wells Fargo, The Weinstein Company, Uber, Volkswagen and Wynn Resorts reveal a common thread in that, at the time of their failures, each company’s board lacked diversity and was unable or unwilling to fully understand the extent of their non-financial ESG issues, risks and opportunities, according to a recent study.

Regulators are keen to investigate and punish individual officers rather than the entity, forcing directors into increased personal scrutiny to provide assurance that they did everything possible to prevent such cases from occurring.

“The social media temperature of a company is a factor examined by D&O underwriters to gauge reputational views.”

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4 LSE, Grantham Research Institute et al., Global trends in climate change litigation: 2019 snapshot, July 2019
5 Harvard Law School, Review and Analysis of 2018 US Shareholder Activism, April 5, 2019
6 Risk Management, Pale, Stale and Male: Does Board Diversity Matter? September 4, 2018
ACCELERATION OF SECURITIES CLASS ACTIONS

Securities class actions, most prevalent in the US and Australia, are growing globally as legal environments evolve. AGCS has seen growing receptivity of governments to collective redress and class actions. Significantly, the EU has proposed enacting a collective redress model to allow for class actions across the union, while several of its states, such as Germany, the Netherlands and the UK, have established collective redress procedures. Canada is also an active class actions venue, and Saudi Arabia recently introduced a class action regime, including a special securities disputes tribunal. The pace of filing activity in the US in 2019 has been only marginally slower than record highs of 2017 and 2018, when there were over 400 filings, almost double the average number of the preceding two decades, and the highest since the bursting of the dot-com bubble in 2001. There were 198 new federal class action securities fraud lawsuits in the first half of 2019 (see left).

This increased activity is impacting both US domestic and foreign companies which have securities listed directly in the US or indirectly via American Depository Receipts (ADRs), although even the lowest-risk ADR level 1 securities, which require the lowest level of compliance to US laws, are becoming increasingly subject to securities class actions. Investors, regulators and media demand speedier disclosures by companies, which causes a strain on accuracy and accountability. Companies and directors are also eager to share faster via social media.

Shareholder activism has also increased. According to Cornerstone Research, approximately 82% of public company merger transactions valued over $100mn gave rise to litigation by shareholders of the target company threatening that the target company’s board will have breached its duties by underpricing the company, should the merger succeed.

ECONOMIC AND POLITICAL CLOUDS AHEAD

With most experts including Allianz economists predicting a slow-down in economic growth, AGCS expects to see increased insolvencies which will translate into D&O claims. Business insolvencies rose in 2018 by more than 10% year-on-year, owing to a sharp surge of over 60% in China, according to Euler Hermes. This higher number of bankruptcies was driven by a persistent high level of large business insolvencies – 247 totaling more than €100bn ($111.5bn) in turnover between Q1 and Q3 2018. In 2019, business failures are set to rise for the third consecutive year by more than 6% year-on-year, with two out of three countries poised to post higher numbers of insolvencies than in 2018. Political challenges, including significant elections, Brexit and trade wars, could create the need for risk planning for boards, including revisiting currency strategy, merger and acquisition (M&A) planning and supply chain/sourcing decisions based on tariffs. Poor decision-making may also result in claims from stakeholders.

Note:
1. There were two cases in 2011 that were both an M&A filing and a Chinese reverse merger filing. Those filings were classified as M&A filings to avoid double counting.
2. Assumes the number of filings in the second half of 2019 will equal the first half.

Source: Cornerstone Research, 2019
LITIGATION FUNDING A GLOBAL INVESTMENT CLASS

All of these mega trends are further fueled by litigation funding now becoming a global investment class, attracting investors hurt by years of low interest rates searching for higher returns – a 2016 study indicated average return on investment (ROI) to be around 36% annually. Litigation finance reduces many of the entrance cost barriers for individuals wanting to seek compensation, although there is much debate around the remuneration model of this business. Recently, many of the largest litigation funders have set up in Europe. Although the US accounts for roughly 40% of the market, followed by Australia and the UK, other areas are opening up, such as recent authorizations for litigation funding for arbitration cases in Singapore and Hong Kong. Next hotspots are predicted to be India and parts of the Middle East. Estimates are that the litigation funding industry has grown to around $10bn globally – up to half of that in the US market, although some put the figure much higher in the $50bn to $100bn range, based on billings of the largest law firms.

COLLECTIVE ACTIONS AND LITIGATION FUNDING: A GLOBAL SNAPSHOT

Securities group actions are on the rise across the globe. While countries such as the US, Canada and Australia see the highest activity and most developed securities class action mechanisms, overall, such mechanisms are developing and strengthening around the world, with the Netherlands, Germany and England and Wales showing notable development and increased activity in recent years.
Although around $15bn of premiums are collected annually for D&O insurance, the profitability of the sector has been challenged in recent years due to a number of factors including increasing competition, growth in the number of lawsuits and rising claims frequency and severity. The loss ratio for D&O insurance has been estimated by various third parties to be in excess of 100% in numerous markets including the UK, US and Germany since 2017 due to drivers such as event-driven litigation, collective redress developments, regulatory investigations, pollution, higher defense costs and a general cultural shift even in civil law countries to bring more D&O claims both against individuals and the company in relation to securities. AGCS has seen double digit growth in the number of claims it has received over the past five years.

The increased claims activity combined with many years of new capital and soft pricing in the D&O market has resulted in some reductions in capacity. The increase in number, size and tail of claims (combined with older claims developing much later) also impair the ability of smaller carriers to compete in the market. For example, AGCS has seen many claims that were notified between 2012 and 2015 only in the last 12 months develop to a point in which the insurer can make either a realistic reserve assessment or a payment. Hence, there is a double-impact of prior year claims being more severe than anticipated and a higher frequency of notifications in recent years. As for claims severity, marketplace data suggests that the aggregate amount of alleged investor losses underlying US securities class action claims filed last year was a multiple of any year preceding it. AGCS has seen more new filings overall, as well as a much higher frequency of claims at the upper bands of severity.

Despite rising claim frequency and severity, the industry has labored under a persistent and deepening soft market for well over a decade before seeing some recent hardening. Market reports estimate that the D&O insurance industry has under-reserved for losses by somewhere between $3bn to $5bn in recent years — a significant portion of premiums earned even as loss ratios are among the highest since the financial crisis. Publically-disclosed data suggests D&O market pricing turned modestly positive in 2018 for the first time since 2003. Market pricing at the end of 2018 was still around 20% to 25% below even 2010 levels and a fraction of the level from the prior market top in the early 2000s, according to reports. However, accounts suggest rate momentum has accelerated further in 2019. According to Aon, D&O rates per million of limit covered were up 17.1% in Q2 2019, compared to the same period in 2018, with the overall price change for primary policies renewing with the same limit and deductible up almost 7%. Primary policies renewing with the same limit were at 93.5% in Q2 2019, but only 70.6% renewed with the same deductible and 66% at the same limit and deductible, suggesting tightening terms and conditions. Still, over 92% of primary policies renewed with the same carrier.

Insurers are facing more legal costs as attorney activity from plaintiffs requires more claims handling, as well as more settlements and claims. Another issue has been that event-driven litigation results in aggregation issues where multiple policies may be

<table>
<thead>
<tr>
<th>SEMIANNUAL CLASS ACTION FILINGS SUMMARY</th>
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<tr>
<td><strong>Class Action Filings</strong></td>
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<td>Average</td>
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<td><strong>Core Filings</strong></td>
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<tr>
<td><strong>Maximum Dollar Loss ($ billions)</strong></td>
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Source: Cornerstone Research, 2019

OUTLOOK FOR THE D&O INSURANCE MARKET
The structure of a D&O insurance policy depends on which of three insuring agreements are purchased (ABC policies are generally chosen, as these are standard form policies for publicly listed companies; for private or non-profit companies, only AB policies would be useful).

<table>
<thead>
<tr>
<th>Cover</th>
<th>Description</th>
<th>Who is the insured?</th>
<th>What is at risk?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Side A</td>
<td>Protects assets of individual directors and officers for claims where the company is not legally or financially able to fund indemnification</td>
<td>Individual officer</td>
<td>His/her personal assets</td>
</tr>
<tr>
<td>Side B</td>
<td>Reimburses public or private company to the extent that it grants indemnification and advances legal fees on behalf of directors/officers</td>
<td>Company</td>
<td>Its corporate assets</td>
</tr>
<tr>
<td>Side C</td>
<td>Extends cover for public company (the entity, not individuals) for securities claims only</td>
<td>Company</td>
<td>Its corporate assets</td>
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D&O INSURANCE STRUCTURE

RISK MITIGATION AND INSURANCE: GUIDANCE AND BEST PRACTICE

There are a number of ways businesses can protect themselves in the current D&O space. They may consider taking more entity risk on the company balance sheet via higher Side-C and Side-B retentions, as well as consider vertical co-insurance, reduce their Side-C limit and purchase more Side-A cover for individual officers. Other suggestions would be to coordinate and tie-in international insurance solution limits, if appropriate, or remove sub-limited extensions which may be easily self-insured. Considering alternative risk solutions is also a way to get optimum protection. For example, multi-year solutions can be structured that allow companies to retain more D&O exposures while effectively reducing earnings volatility.

As AGCS continues to see non-financial indicators as a major risk predictor, businesses should meet with their brokers for detailed advice on options, as well as open dialogue with underwriters in order to better understand their risk culture and governance. Underwriters need clarity from customers about cyber and privacy risk exposures, their corporate governance set-up, intangible asset protections, reputation and brand protections, crisis management plans, and how risks are monitored and managed at the board level. Brokers should engage with AGCS as early as possible to ensure any policy changes are communicated appropriately. AGCS is always happy to have specific conversations with current or prospective customers and by sharing these insights hope it also helps boards with risk blind spots and opens a mutual risk dialogue.

AGCS also encourages engagement with our ESG and teams for expert risk mitigation advice.
ABOUT D&O INSURANCE

D&O Insurance covers current, future and past directors, as well as non-executive directors, subsidiaries, and officers of a company. The risk scenarios covered include prospectus liability, pension trust liability and employment practices liability. And in specific cases, such as securities claims, the cover can be extended to cover the company itself.

D&O insurance can also be used to recover defense costs and financial losses, as well as costs incurred by administrative, investigative and criminal proceedings.

For more information visit
agcs.allianz.com/solutions/financial-lines-insurance/d-and-o-insurance.html